No. 76-843

In the Supreme Court of the United States

OCTOBER TERM, 1976

CASCO BANK & TRUST CO. AND RITA B. PRESTON, CO-EXECUTOR AND CO-EXECUTRIX OF THE ESTATE OF WILLIAM A. PRESTON, JR., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

DANIEL M. FRIEDMAN,
Acting Solicitor General,

MYRON C. BAUM,
Acting Assistant Attorney General,

RICHARD FARBER,
JAMES E. CROWE, JR.,
Attorneys,
Department of Justice,
Washington, D.C. 20530.

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OPINIONS BELOW

The opinion of the district court (Pet. App. A 14-21) is not officially reported. The opinion of the court of appeals (Pet. App. B 22-35) is reported at 544 F. 2d 528.

JURISDICTION

The judgment of the court of appeals was entered on September 21, 1976. The petition for a writ of certiorari was filed on December 20, 1976. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether advances made to a closely-held corporation by its principal shareholder were contributions to the corporation's capital and not debt, so that the corporation's

subsequent insolvency did not justify the shareholder's claimed bad debt deduction under Section 166 of the Internal Revenue Code.

STATUTES INVOLVED

The pertinent provisions of Sections 165 and 166 of the Internal Revenue Code of 1954 (26 U.S.C.) are set forth at Pet. App. B 36-38.

STATEMENT

Petitioners are the co-executor and co-executrix of the estate of William A. Preston, Jr. Prior to his death, Preston had engaged in the construction business, first in partnership form and then as a sole proprietor. In 1968, he incorporated his business as Maloney & Preston, Inc. (M & P), with an initial capital investment of $20,000. Preston received 51 of the 53 shares of the M & P stock that were issued, and controlled M & P's business operations and financial affairs. M & P reported gross sales of about $1,500,000 and $1,900,000 in its first two taxable years of operation, ending March 31, 1970 and 1971 (Pet. App. B 23-25).

As part of the business of constructing public facilities, M & P was required to secure bid, performance, and payment bonds. Preston obtained these bonds largely from Maine Bonding & Casualty Co. Because of M & P's extremely limited capitalization, Maine Bonding required Preston and his wife, as a condition to issuance of the bonds, to indemnify Maine Bonding against any losses it incurred on the bonds (Pet. App. B 24, 30-32).

Preston customarily made cash advances to M & P to relieve its cash flow problems. M & P never issued any notes or other evidences of indebtedness to Preston and never paid him any interest with respect to these advances. The accountant's worksheet, which was subsequently

prepared for tax purposes, reflected these advances as amounts "Due Wm. A. Preston." As contract payments came in, Preston would withdraw cash from M & P which was not needed in its business (Pet. App. B 24-25).

In 1969, M & P began to experience financial difficulties, and the situation became critical in 1971 when M & P was unable to meet its obligations on a hospital construction contract. After meeting with an officer of Maine Bonding, Preston paid M & P's obligations to its subcontractors and suppliers on that contract by personally advancing approximately $94,000 to M & P. Preston's wife testified that he intended to keep the corporation active by this advance, but no additional work was forthcoming and M & P was dissolved in late 1971. The net figure shown on M & P's final worksheet as "due Wm. A. Preston" was $105,807.46, which was uncollectible at that time (Pet. App. B 25-26).

On his 1971 income tax return, Preston claimed the $105,807.46 unpaid advance from M & P as a business bad debt under Section 166(a) of the Code. Preston took part of this deduction as a carryback adjustment[1] to 1968, which resulted in a refund for that prior year. On audit, the Commissioner of Internal Revenue disallowed the claimed deduction and determined a deficiency in the amount of the refund previously paid (Pet. App. B 22-23, 26).

After a jury trial in this refund suit brought by petitioners in the United States District Court for the District of Maine, the jury returned special verdicts finding that Preston's advances to M & P were bona fide debt, and

[1]Preston also claimed a loss on the worthlessness of Section 1244 stock. That provision permits an ordinary loss deduction for the worthlessness of certain small business corporation stock. The Commissioner's disallowance of that deduction was upheld by the courts below and is no longer at issue (Pet. 5).

that such debt was created in connection with Preston's trade or business. These findings would have upheld Preston's claimed deduction of the entire amount of the final net advances as a business bad debt under Section 166(a) of the Code. However, the district court granted the government's motion for judgment notwithstanding the verdict, stating that "no reasonable person could have concluded that the advances made by Mr. Preston to the corporation were loans and not contributions to capital" (Pet. App. A 18-19).[2]

The court of appeals unanimously affirmed. It held that the record did not show that Preston's advances to his corporation created bona fide indebtedness. In so holding, the court of appeals rejected petitioners' argument that the indemnity agreement established that Preston's advances were debt as a matter of law (Pet. App. B 29-35).

ARGUMENT

The facts of this case amply support the decision below that Preston's advances to his closely-held corporation were contributions to capital and not loans. As the court of appeals observed (Pet. App. B 30-31), the corporation was grossly undercapitalized, did not issue any notes, pay any interest, pledge any collateral, or set any fixed time for repayment. Indeed, the district court found (Pet. App. A 18) that there was "no record indicating that there was *any* undertaking by the corporation to repay the advances" (emphasis in original). Under these circumstances, the advances cannot be characterized as debt for federal tax purposes.

[2]The loss on the advances was therefore deductible only as a capital loss from the worthlessness of stock under Section 165(f) and (g) of the Code.

Petitioners assert (Pet. 6-8) that the decision below conflicts with *Putnam* v. *Commissioner*, 352 U.S. 82. In that case, the issue was whether a shareholder's payments to his insolvent corporation's creditor pursuant to his guaranty of the corporation's debt gave rise to an ordinary loss deduction under the statutory predecessor of Section 165 (c)(2) (losses incurred in a transaction entered into for profit), or were a nonbusiness bad debt deductible as a capital loss under the predecessor of Section 166. The Court held that the guaranty payments gave rise to a nonbusiness bad debt loss, pointing out that the result was in accord with the overall statutory scheme that losses incurred by individuals in providing financing to a corporation, in the form of direct loans or stock investment, were capital and not ordinary losses.

Putnam, however, does not support petitioners' contention that where, as here, a shareholder executes an agreement to indemnify his corporation's creditors, all subsequent advances made by the shareholder to the corporation must be regarded as debt even though the advances possess none of the traditional characteristics of indebtedness. The threshold question whether shareholder advances to a corporation are debt or equity was not presented in *Putnam*. Since *Putnam* does not speak to the issue here whether Preston's advances were loans or contributions to his corporation's capital, the decision below does not conflict with *Putnam*.[3] Indeed, as the

[3]Contrary to petitioners' further assertion (Pet. 9-10), the decision below does not conflict with *Horne* v. *Commissioner*, 523 F. 2d 1363 (C.A. 9), *Martin* v. *Commissioner*, 424 F. 2d 1368 (C.A. 9), certiorari denied, 400 U.S. 902, *United States* v. *Hoffman*, 423 F. 2d 1217 (C.A. 9), and *Stratmore* v. *United States*, 420 F. 2d 461 (C.A. 3), certiorari denied, 398 U.S. 951. Those cases, like *Putnam*, involved attempts by guarantors of corporate obligations to obtain ordinary loss treatment under Section 165(c)(2), and the courts there did not address the debt-equity issue presented here.

court of appeals correctly noted (Pet. App. B 34), since *Putnam* the courts have consistently utilized traditional debt-equity analysis to determine the tax treatment of shareholder advances.[4] See, *e.g.*, *Plantation Patterns, Inc.* v. *Commissioner*, 462 F. 2d 712 (C.A. 5), certiorari denied, 409 U.S. 1076.

CONCLUSION

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

DANIEL M. FRIEDMAN,
Acting Solicitor General.

MYRON C. BAUM,
Acting Assistant Attorney General.

RICHARD FARBER,
JAMES E. CROWE, JR.,
Attorneys.

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[4]Likewise, Congress has recently agreed that a guaranty of corporate obligations should be scrutinized under debt-equity criteria before allowing bad debt treatment under Section 166. Section 605(a) of the Tax Reform Act of 1976, Pub. L. 94-455, 90 Stat. 1575, repeals Section 166(f) of the Code, which dealt with bad debt treatment of losses resulting from the guaranty of noncorporate obligations. The accompanying report of the House Ways and Means Committee states as follows (H.R. Rep. No. 94-658, 94th Cong., 1st Sess. 177 (1975)):

> The committee also wishes to make it clear that in the case of a guarantor of a corporation obligation, any payment under the guaranty agreement must be deducted (if at all) as a nonbusiness bad debt, regardless of whether there is any right of subrogation, unless the guaranty was made pursuant to the taxpayer's trade or business. Of course, if the payment under the guaranty by a corporate shareholder constitutes a contribution to capital, under the facts and circumstances of the particular case, the payment would not be deductible but would increase the stockholder's basis in his shares in the corporation. This rule is consistent with the committee's understanding of present law.